

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

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In the Matter of)	
)	
Price Cap Performance Review)	CC Docket No. 94-1
for Local Exchange Carriers)	

JUN 29 1994

**REPLY COMMENTS OF
THE OFFICE OF THE CONSUMERS' COUNSEL
STATE OF OHIO**

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INTRODUCTION

Most of the LEC commenters to the Notice of Proposed Rule Making (NPRM) claim that price caps have been a success, but need improvement. "Improvement" is defined as removing regulatory restraints on the price cap LECs. Most of the LECs also seek new objectives for the price cap regime... to justify removing regulatory restraints.

Amidst all of this hullabaloo, the Office of the Consumers' Counsel, State of Ohio (OCCO) urges this Commission not to gloss over the more fundamental questions presented by price caps. One of those questions is whether price caps per se are even necessary. This question is addressed by the Organization for the Protection and Advancement of Small Telephone Companies (OPASTCO) comments, which reveal quite clearly the lack of defect in traditional utility regulation. OPASTCO at 4-5. In particular, OPASTCO's comments show how traditional regulation has enhanced infrastructure development.

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In these reply comments, OCCO will not focus on the many parties with positions substantially identical to ours. Rather, OCCO will attempt to show the errors in the arguments of certain other parties (principally price cap LECs) who seek to obscure the historical impacts of the price caps, or who seek to redirect the goals of price caps to serve their own interests.

Because of the sheer bulk of the comments filed, OCCO has focused its review on the comments of the LECs that serve our state: Ameritech, Cincinnati Bell, GTE, and United. Certain others are discussed here as well. We must leave to others a detailed discussion of the USTA comments. The 500+ pages of their comments and studies require an equally detailed response.

GENERAL ISSUE 1: Changing Goals

When reading some of the comments, you would think that the original purpose of price caps had already disappeared:

"[E]stablish[ing]... the ground rules under which investment in the NII will be made by competing firms... is the challenge the Commission faces in this proceeding." GTE at 2. OCCO submits that developing such ground rules is a task for other dockets (many of which are already open) and has little to do with the true purpose of price caps.

The National Rural Telecom Association (NRTA) does not even mention the goal of price caps as a means of replicating the competitive market, before supporting new economic growth and universal service objectives. NRTA at 1. NRTA's focus (on the

sale and trade of rural exchanges) should, like those new secondary objectives, have only a tangential relation to the price caps being addressed here. The OPASTCO is much more realistic in this regard. OPASTCO at 2.

We cannot help but note that Citizens for a Sound Economy (CSE) has apparently adopted a hitherto-unmentioned new goal for price caps: the ratification and legitimization of monopoly rents. When "[t]he benefits of price caps that do not flow to consumers flow to stockholders..." (CSE at 4), that is because those captive customers are paying rates higher than would obtain in a competitive market.

By contrast, Wiltel's lengthy argument for refinements to the price cap mechanism in order to enhance access competition (Wiltel at 10) really does not represent a "new" goal. Rather, Wiltel believes that the best way of replicating the price discipline of a competitive market is to make the market more competitive in actuality, a goal even the LECs purport to support.

GENERAL ISSUE 2: Benefits of Price Caps

Sprint and United/Central (Sprint) claim that United's performance under price caps has been "good". Sprint at 1-2. A mild endorsement at best, but even less forceful when the "benefits" Sprint touts are examined: They have little to do with the interstate jurisdiction, and equally little to do with a price caps scheme that controls access charges. See also Sprint at Attachment 1, third paragraph; Ameritech at 7.

The fundamental question for price caps is, have they "forced" price discipline on monopoly services? Ameritech reveals that the answer is negative, admitting that the extent to which its rates are below the caps "is more an indication of competitive pressure... than... the result of the price cap itself." Ameritech at 1. Thus lack of such pressure still allows Ameritech's other rates to be higher than they would otherwise be.

GTE, while attempting to defend price caps, also actually shows how unnecessary they are: GTE demonstrates that its responses to competitive pressures have produced a disproportionate share of the price caps' benefits. GTE at 14. This could have occurred under a flexible rate of return regime as well, but more importantly shows that the price caps themselves are not adequately replicating a competitive market.

BASELINE ISSUE 1a: Infrastructure Development

Sprint argues (at 3) that loosening the profit restraints on price cap LECs will encourage investment in regulated infrastructure instead of unregulated activities. But it is clear that not all additional profits will flow to regulated activities; investments in unregulated activities will still occur, and will, therefore, be increasingly funded by the LECs' monopoly on local access. This would be economic waste of a high order.

BASELINE ISSUE 1b: Universal Service

Although Ameritech apparently agrees with OCCO that specific universal service goals need not be part of price caps, OCCO very strongly disagrees with Ameritech's rationale: It is based on a fundamentally erroneous proposition that current residential rates are "artificially suppressed" because of the "current carrier common line charge subsidy to end user-generated non-traffic sensitive costs...." Ameritech at 5. Given the claimed breadth and depth of this "subsidy", Ohio Bell Telephone Company (a/k/a "Ameritech-Ohio"), in its Ohio alternative regulation case¹, has managed to allege only that residential access, in certain density zones, is currently priced below long run service incremental cost. Ohio Bell simply could not make an allegation that the full package of residential basic service is underpriced. Further, Ohio Bell's incremental studies load all costs of the local loop onto basic services. That certainly is not an "economically efficient" allocation.

Ohio Bell's definition of an economically efficient system is clear. It is monopoly rents, it is Ramsey pricing, it is anticompetitive action: It is allowing Ameritech the ability to increase the basic rates of the 94.2% of the population who currently have telephone service. NPRM at ¶29. Of course, Ameritech would be able to do so only because the societal demand for telephone service is fundamentally inelastic. OCCO

¹ Public Utilities Commission of Ohio Case No. 93-487-TP-ALT, currently in litigation.

urges this Commission to recall that the Communications Act of 1934 does not demand economic efficiency; it demands that we "make available, so far as possible, to all the people of the United States,... communications service with adequate facilities at reasonable charges...." 47 U.S.C. Section 151 (emphasis added).²

Further, the Commission should be aware that after a full evidentiary hearing, the Maine Public Utilities Commission recently found that the "residential subsidy" had not been proven. New England Telephone, Docket No. 92-130, Order (April 13, 1994) at 39-40.

BASELINE ISSUE 1c: Fiber Levels

The statistics Ameritech cites (at 7) reinforce OCCO's original view that increasing the replacement of copper technology with fiber by large LECs: a) is largely not within this Commission's jurisdiction³; b) is occurring without the Commission's intervention; and c) for a number of reasons (economic efficiency being one of them), should not be an objective of this Commission's price cap plan. See also GTE at 15.

² Ameritech's characterization of the fact that one in four of the lowest income level households is without phone service as "indicating that telephone penetration is somewhat sensitive to household income levels below a certain threshold figure..." (*id.*) shows little commitment to the Act's explicit universal service goal.

³ Unless perchance the fiber is being laid largely to provide interstate services; in that case, of course, the costs of that fiber should be largely attributed to the interstate jurisdiction.

BASELINE ISSUE 3a: Changes to Formula

Productivity Factor Ameritech acknowledges (at 12) that it is only an "assumption" that "the productivity factor was set correctly in the first instance...." but Ameritech opposes strengthening the factor because to do so "would impose retroactively the very disincentives to efficiency... that price caps was supposed to correct." Id. However, if there is no recognition of increased productivity, the LEC retains all the benefits. In a competitive market, efficiency gains must be "shared" with consumers through reduced prices. Such a sharing should, therefore, occur under price caps.

As with the sharing mechanism (see below), Ameritech says that the productivity factor should not be raised, because "[i]f any increased productivity is wrested from subject carriers, the 'incentive' portion of the plan will be seriously compromised." Ameritech at 3. Ameritech's error here is obvious: How can increasing pressure on the LECs to be more efficient by more closely reflecting real-world productivity increases, and increasing benefits to customers, which both were the original purposes of the plan, compromise those purposes?

Although OCCO has not reviewed the USTA Comments in detail, we must note here the fundamental contradiction embodied in USTA's proposal to almost halve the productivity factor embodied in the price cap formula. USTA at 84. USTA has used the benefits resulting from the current formula as a major selling point, yet gives no indication of how much of that benefit would have occurred if the USTA productivity factor had

been in effect for the last few years. OCCO submits that this is not the time to ease up on the LECs.

Interest Rates CSE says that changes in interest rates should not be included as an exogenous factor because doing so might diminish LECs' incentives to prudently time investments and manage debt. CSE at 5. Contrary to CSE's claim, "adjusting price caps to reflect interest rate changes..." is in fact necessary to replicate a competitive market, where such changes would exert downward pressure on price in an investment-intensive industry. A price cap scheme created in a time of substantially-higher interest cost must be massaged to show current economic realities.

Ameritech argues that no adjustment need be made, because interest rates are already factored into "the GNPPI." Ameritech at 13; see also GTE at 77. Although interest cost is indeed a cost for all firms in the economy (id.), the point is that it is a more significant element of cost for a LEC than for the average firm. Thus failing to make an explicit adjustment for the decline in interest rates since the FCC selected the 11.25% return would allow the LECs to retain all of their "interest decrease benefit."⁴

⁴ Given that the LECs have enjoyed that benefit since not long after the rate was set, the FCC should display the same forbearance to raise the rate, if it ever becomes necessary, that was used in lowering the rate.

BASELINE ISSUE 3c: LEC Profit Levels

OCCO believes that the Commission should note the totally unsupported nature of Ameritech's claim that "Yes, price caps LEC profits levels are reasonable". Ameritech at 13.

BASELINE ISSUE 4a: (See "Interest Rates", *supra*.)

BASELINE ISSUE 4b: Sharing Mechanism

Curiously, CSE argues that because of the claimed benefits of price caps (which have been achieved in an environment including a sharing mechanism), therefore a sharing mechanism is no longer needed. OCCO submits that the opposite is true: The sharing mechanism must be strengthened in order to increase the benefits.

Ameritech argues that sharing should be eliminated because it "dilutes the incentive to engage in ["productivity efforts"] in the first instance." Ameritech at 2. Even if such "dilution" occurs, customers still benefit, because absent sharing, there is no guarantee that customers will see any result from the cost-reduction actions of the LECs.

Ameritech claims that "the regulation of carrier earnings is not necessary to ensure just and reasonable rates...." Ameritech at 14. This is based on the self-serving premise that "[r]ates that comply with the price cap formula are reasonable because they have been kept in line relative to inflation." Id. Yet merely being "kept in line" relative to inflation barely comes close to what would be occurring in a competitive market having declining cost characteristics

similar to the carrier market. Thus until the carrier market is more competitive, only a sharing mechanism can prevent the extortion of bottleneck monopoly rents.

Sprint, on the other hand, argues that sharing should be eliminated because it complicates things. Sprint at 6-7. Yet the speculative benefits of removing this complicating constraint (id. at 6) cannot substitute for the actual price discipline provided by the sharing mechanism.

GTE presents figures which show that "market forces, rather than the cap and sharing mechanisms, have effectively constrained GTE's earning during the 1991-1993 period." GTE at 15. However, the record is also clear that GTE may be the only LEC to be so consistently constrained, since the other LECs have consistently overearned (and now seek opportunities to enhance that position). Thus GTE's experience shows that the sharing mechanisms must be maintained, to discipline those firms not as willing to bow to market forces.⁵

USTA's Dr. Harris argues that the LECs profits levels do not require a backstop mechanism because: 1) the profits really aren't all that high because of "uneconomic" depreciation rates; and 2) "high profits do not necessarily mean that the price cap formula was incorrect...." Harris at 19. OCCO will leave to others the discussion of depreciation rates, but will note that Dr. Harris' argument that high profits

⁵ OCCO cannot help but note that in Ohio at least, GTE is consistently the weakest performer on the intrastate level. This is not due to GTE's superior market responsiveness; so perhaps the interstate performance is equally not entirely the result of such responsiveness.

may simply mean that the LEC did extremely well in the marketplace and/or in managing its business efficiently. There are companies, in unregulated, competitive markets, which earn high rates of return in some periods. Why should we expect that it could not happen in local exchange telecommunications?

scarcely explains the almost-across-the-board consistency of LEC profit levels. High-earning firms in a competitive market tend to do so because of some special expertise or a unique product. Neither of those conditions obtains in the local exchange telecommunications market.

BASELINE ISSUE 6: Exogenous Factors

NRTA's take on the exogenous factor issue is to promote the salability of its properties. NRTA at 7. However, to argue that if exogenous cost deductions for exchange sales are required then "sales of exchanges would cease or decline" surely exaggerates the materiality of such impacts. (If not, this is just another example of the need for a far-reaching examination of the actual cost of telephone service in the U.S., as we embark on the new competitive paradigm.)⁶

⁶ NRTA has its paradigms confused as well. If "it is not likely that price cap LECs would upgrade rural network capabilities if they could not recover the additional costs... through higher rates...", are not the LECs clinging to the most basic principle of the supposedly outmoded rate base rate of return regulation?

BASELINE ISSUE 7: Service Quality

OCCO originally emphasized the need for the Commission to act upon the reports of service quality made by the price cap LECs. The Tele-communications Association (TCA) points out an equally important function of such reporting: providing customers with information on which to base their purchasing decisions. However, residential customers by and large lack the ability to act on such reports. Therefore, as argued by OCCO, the Commission must protect the public interest by enforcing quality standards on behalf of captive customers.

BASELINE ISSUE 8: New Services

Ameritech's view of the pricing of new services is that the Commission should not require such services to bear a reasonable share of the LEC's common costs. Ameritech at 23. At the other extreme, Ameritech also believes that new services need no price ceiling. Id. at 26. This latter position leads to profit maximizing and output restriction, which reduces social welfare.

The end result of price freedom for new services is that the LEC's monopoly consumers are asked to support the LEC's positioning in the market for those services. That is hardly "economically efficient" or pro-competitive.

On the other hand, we can understand the LECs' frustration with a process that seems to impede new service introduction. See, e.g., Ameritech at 24; GTE at 10-11. Surely there is a

happy medium: An expedited process which nonetheless assures that prices are just, and assures that they are reasonable.⁷

BASELINE ISSUE 6c: Third Party-Proposed Exogenics

Ameritech's position opposing third party-proposed exogenous changes simply fails to acknowledge the Commission's concern in this area: that LECs have no incentive to request exogenous changes that would decrease rates. Allowing others to propose such changes merely balances the game; that cannot be "inappropriate." Ameritech at 19.

TRANSITION ISSUE 1a: Levels of Competition

OCCO will leave it to those with the most direct knowledge of the level of competition for LEC services (their competitors) to show the exaggerations in the LECs' assessment of that level. See, e.g., Ameritech at 8-11, 29-30; GTE at 28-38. However, given the competitors' own economic interest, perhaps large customers' assessments of competition should also be considered, as a "reality check."

Almost without exception, the price cap LECs (and USTA) argue that the constraints of the price cap scheme should be loosened, to allow the LEC plan to be closer to AT&T's. See,

⁷ Ameritech itself must be somewhat responsible for the fact that one-third of its new service offerings have been delayed three months (Ameritech at 24); these delays cannot entirely be attributed to voraciously unfair competitors and customers, as Ameritech alleges.

e.g., USTA at vi, 10-12. However, despite the voluminous information provided on CAP and other forms of competition, none of the LECs seem to realize that the competition for their services at best is nowhere near the level faced by AT&T.⁸

TRANSITION ISSUE 1b: Transition From Price Caps

CSE warns the Commission not to worry about levels of competition, because supposedly even contestable, concentrated, and oligopolistic markets adequately replicate the discipline of a fully competitive market. CSE at 9. Of course, "contestability" is a thoroughly discredited theorem.⁹ It may be that in some instances a concentrated market is a

⁸ A cautionary note is required here: Even with AT&T, the recent requests for rate increases (followed virtually lockstep by other IXCs) are strong suggestions of a market that is not as competitive as the Commission presumes. Neither are AT&T's profit levels (see USTA at 16) consistent with those which would be earned in a truly competitive market, which suggests that much of the access pricing benefits of price caps has not been passed along to consumers.

⁹ William G. Shepherd, "Contestability v. Competition," American Economic Review (September 1984), pp. 572-587; A. Jacquemin, The New Industrial Organization (Oxford: Clarendon Press, 1987); J. Vickers, "Strategic Competition Among the Few," Oxford Review of Economic Policy (Autumn 1988), pp. 39-62; Marius Schwartz, "The Nature and Scope of Contestability Theory," in Strategic Behavior and Industrial Competition, edited by D.J. Morris et al. (Oxford Clarendon Press, 1986), pp. 37-57; and J.E. Stiglitz, "Technological Change Sunk Costs and Competition," Brookings Papers on Economic Activity, No. 3 (1987), pp. 883-937. Thomas Gale Moore, "U.S. Airline Deregulation," Journal of Law and Economics (April 1986), pp. 1-28. See also Samuel H. Baker and James B. Pratt, "Experience as a Barrier to Contestability in Airline Markets," Review of Economics and Statistics (May 1989), pp. 352-356; and G.D. Call and T.E. Keeler, "Airline Deregulation Fares and Market Behavior: Some Empirical Evidence," in Analytical Studies in Transport Economics, edited by A. Daugherty (New York: Cambridge University Press, 1985).

sign of efficiency (CSE at 9-10); however, we submit that a concentrated market which emerges from a monopoly has not developed solely as a result of the former monopolist's "efficiency."

TRANSITION ISSUE 5: *Timing of Further Review*

Ameritech says that there is no need for regular reviews of the plan. Ameritech at 34. Like Ameritech's position on third party-proposed exogenous changes (see Baseline Issue 6), this will result in opportunities for the LECs to "game the system", because the LECs themselves will have incentive to seek review only when tweaking the plan would be to their advantage, especially given their greater access to information about the workings of the plan.

CONCLUSION

The deadline for these reply comments has been extended twice. It certainly appears from OCCO's perspective that the Commission has still not allowed nearly enough time for reply, given the importance of this docket and the sheer volume of the comments filed by certain parties. USTA's many hundreds of pages of comments and studies certainly require a response not constrained by such deadlines.


However, even under these constraints, OCCO believes that we have identified major flaws in the evidence and reasoning of the LECs attempting to show support for loosening the price caps' constraints. We submit that following the LECs' lead

will have, at best, a minimal effect in replicating the benefits for consumers of a competitive market. The major effect will be in enhancing the LECs noncompetitive earnings, and will undermine the emergence of further competition in the interstate access market. These ends are consistent neither with the Commission's statutory goals nor with the specific goals that resulted in adopting the LEC price cap regime.

The general revisions to the plan supported by OCCO in our original comments, as fleshed out by the comments of other nonLEC parties, will, on the other hand, improve the performance of the price cap plan in enforcing quasi-competitive constraints on the still largely monopoly access market. The Commission will, as always, have a difficult job at hand in balancing the varied interests of the stakeholders in this arena.

Respectfully submitted,

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